Financial Markets

Irving Trust

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Friday May 16, 1980

After bringing many short-term rates to close to half of their early April levels, the great six-week credit market rally finally halted this week. Last week, the rally hesitated as Fed actions implied resistance to more drops in interest rates. This week, hesitation turned to a full stop as Fed statements confirmed a more resistant attitude than has been manifest in recent weeks.

To quote Mr. Volcker's Thursday Congressional testimony: "I would expect to see it [money supply] move higher." This shouldn't have surprised the markets. Fed statements have stressed that recent money supply drops (in April, M1A fell at an annual rate of 18.5%) were probably due in part to technical and seasonal factors (tax payments), implying that some of the decline was likely to be reversed.

The implication for the Federal funds rate, however--and thus for the general level of interest rates--sent prices sharply lower on Thursday. Funds peaked at 19.96% on April 3 and fell to 10.5% before the Fed moved to steady the rate. The funds drop and the credit market rally were due more to declining credit demand than to Fed supply expansiveness, but the Fed did allow demand factors to pull down rates with little resistance. If money growth turns positive (reversal after April's drop could be sharp), the Fed will presumably be less willing to supply liquidity than it was when money supply was falling rapidly. That means a steadying of the Fed funds rate (some observers suggest 10.5% to 13%), a sharp change from the recent environment of steady drops in funds.

Before the Volcker statement, the government market had begun to back up on a rise in financing costs. Early this week, short-term rates had continued lower; T-bills particularly showed sharp gains on foreign buying and limited supplies of other short-term paper. Inventories jumped Thursday, however (dealers took delivery of securities auctioned in last week's refunding), and financing costs rose to 10.75% from 7% on Wednesday. Friday's report of a 1.9% April industrial production drop was badly received--some had forecast 5%--and fears that a big jump in money supply would be reported Friday afternoon compounded tensions.

The net result was a sharp rise in rates--90-day Treasury bills rose from a low of 8.12% on Wednesday to 9.10% Friday morning; other short rates also rose. In long-term markets, price erosion had set in early in the week and intensified later on; the 30-year Treasury bonds auctioned last week at 98.875 fell to 95.625 by Friday morning. Corporate bond prices also dropped, though a heavy new supply continued to be readily absorbed. In the municipal market, prices fell, and some problems with supply absorption appeared--limited retail demand, heavy inventory, and a $2.5 billion 30-day calendar did not add up to positive news.

For all markets, the key to near-term prospects lies with the Federal Reserve. Recession is already heavily factored into current price levels; thus more bad economic news will not reignite the rally. Only further Fed easing could do that, and further Fed easing does not look likely at the moment. Rallies that stop tend to reverse; thus more temporary rate increases may be on the way unless the Fed steps into the market with more aggressive policy actions.

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Market Yields

	5/16/80	Week Ago	Year Ago
Prime Lending Rate at Irving Trust Company	(noon)		
Short-term loans to substantial depositors with highest credit rating	16.50	17.50	11.75
Effective since	5/16/80		
Discount Rate at Federal Reserve Bank	13.00	13.00	9.50
Federal Funds	11.63	10.63	10.24
Repurchase Agreements	10.25	8.25	9.90
U.S. Treasury Issues			
Bills			
3 months	9.30	9.22	9.93
6 months	9.42	9.56	10.10
1 year	9.58	9.89	10.00
Coupons			
2 years	9.64	9.79	9.71
4 years	9.84	9.95	9.18
7 years	10.20	10.37	9.20
10 years	10.30	10.41	9.22
Long Bond	10.47	10.44	9.20
Negotiable Certificates of Deposit-Secondary Market			
1 month	10.25	10.25	10.05
3 months	10.25	10.25	10.25
6 months	10.10	10.20	10.47
1 year	10.20	10.20	10.55
Banker's Acceptances			
1 month	9.80	9.95	9.93
3 months	9.95	10.00	10.16
6 months	10.10	10.10	10.45
Eurodollar Deposits			
1 month	10.38	10.88	10.38
2 months	10.69	11.38	10.50
3 months	11.13	11.50	10.63
Commercial Paper - Prime Names			
Directly placed by:			
Finance Companies			
1 week	9.25	7.00	9.88
1 month	9.00	9.00	9.90
3 months	8.88	9.25	9.75
Bank Holding Companies			
1 month	9.50	9.38	9.95
Dealer Placed:			
3 months	9.50	9.50	9.98
New AA Corporate Utility Bond	11.85	12.00	10.00
Tax Exempt			
6 month Project Notes	5.50	5.25	4.90
1 year AAA Bond	5.40	5.40	N/A
5 year AAA Bond	5.70	5.35	N/A
20 year AAA Bond	6.90	6.10	5.90

This information represents prevailing market yields.
It should not be construed as an offering.
All yields are on the offered side of the market.

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